

Office of Chief Counsel  
Internal Revenue Service  
**memorandum**

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RVHosler

date: October 24, 2001

to: [REDACTED] Examination Team

from: Associate Area Counsel  
(Natural Resources)

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subject: **Research and Experimentation Credit Update**

I am the LMSB attorney who will be working with the [REDACTED] examination team during its current cycle. I also worked on the prior examination cycle. One of the issues in the prior examination cycle, and an issue that is certain to arise in the current examination, involves the taxpayer's claims for the research and experimentation credit. This memorandum is to provide the examination team with the recent developments affecting the definition of "substantial rights" for purposes of determining whether taxpayer research is funded. This memorandum should not be cited as precedent.

Specifically, the issue addressed herein is whether the opinion of the Federal Court of Appeals in Lockheed Martin Corp. v. United States, 210 F.3d 1366 (Fed. Cir. 2000), changed the standard for determining if a taxpayer retains "substantial rights" in its research results under Treas. Reg. § 1.41-5(d)(2).

BACKGROUND

I.R.C. § 41(a) allows a tax credit for increased qualified research expenses. The tax credit is limited to 20% of the increased expenses. I.R.C. § 41(f) excludes research "funded" by another entity, such as the government. However, the Internal Revenue Code does not define "funded."

Treas. Reg. §§ 1.41-2(a) and 1.41-5(d)<sup>1</sup> set forth two scenarios in which a taxpayer's research will be deemed "funded" by another entity. First, when the parties agree that payment

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<sup>1</sup> Although Treas. Reg. § 1.41-5 states that it applies only to pre-1986 tax years, it should have the same interpretation for post-1985 tax years because I.R.C. § 41 was reenacted without any changes to the funded exclusion to qualified research.

will not be contingent on the success of the research. Second, when the entity conducting the research does not retain substantial rights in the research results.

#### DISCUSSION

Determining whether research is funded, particularly in situations where government contracts are involved, is factually intensive, as evidenced by the reversal of a lower court decision that had denied research credits claimed on amended returns. (See Lockheed Martin Corp. v. United States, 42 Fed. Ct. 485 (1998)). Lockheed Martin Corp. involved credits of about \$64 million claimed on amended returns for 1984 to 1988. The research related to work on approximately 300 contracts with both government and business entities, although about 80% of the costs were incurred on 13 of the largest contracts. [REDACTED]

1. [REDACTED]

2. [REDACTED]

The Service subsequently issued an RAR to LM disallowing research credits for three types of expenditures:

1. Those related to projects where LM did not retain substantial rights in the research.
2. Those where subcontractors may have also claimed the credit.
3. Those associated with certain service contracts that did not require research be incorporated into the deliverable.

Lockheed Martin Corp., 42 Fed. Ct. at 485, dealt with only the credits disallowed due to the substantial rights issue. The parties agreed to resolve this issue by looking only to the rights involved in LM's four major programs.

The contracts included standard regulatory clauses regarding the treatment of patent rights and the government's rights in certain technical data and software. The patent clauses gave LM certain rights, but generally subject to some control by the government, such as requiring LM to grant the government a non-exclusive license. LM did not apply for any patents with

respect to the major programs. The other clauses generally gave the government unlimited rights in the technical data and software generated from work required by the contracts.

Some contract provisions either allowed the government to disclose or required LM to disclose information to other potential suppliers and to the government. The programs were subject to security classification guidelines that required LM to obtain State Department approval before entering into licensing agreements or technology transfers. The contracts also included recoupment clauses allowing the government to recover certain nonrecurring costs related to commercial sales by LM.

LM questioned the validity of Treas. Reg. § 1.41-5(d), defining funded research, because the "substantial rights" part of the definition is not mentioned in the statute. The trial court, on the other hand, found that this was a reasonable interpretation because of the "clear connection between payment for research and the allocation of rights to research results." The court summarized the regulation as requiring that the taxpayer retain some right to use the research as a "minimum prerequisite for satisfying the substantial rights requirement." Yet, neither the researcher nor the funding party had to retain exclusive rights to the research in order to meet the substantial rights requirements. The rights, however, had to be more than incidental benefits, such as increased experience from performing the research. Whether a retained right is substantial depends on the circumstances and the commercial or practical value of the retained right. Lockheed Martin Corp. v United States 42 Fed. Ct. at 498.

The Service took the position that to interpret "substantial rights," guidance could be obtained from I.R.C. § 1235 on whether a patent had been sold or exchanged. Here, the government's unlimited right to use and disclose the technical data greatly diminished the commercial value of LM's right to use the research results. The contractual language placed "considerable restrictions" on LM's ability to use the research results. LM's "actual use of its research results is immaterial, since the parties' contracts and applicable regulations gave the government the power to completely prevent any use of such research." Thus, the trial court held that LM did not retain substantial rights in the research.

In April of 2000, the Federal Court of Appeals reversed the trial court decision to find that LM was entitled to a credit. Lockheed Martin Corp. v. United States, 210 F.3d 1366 (Fed. Cir. 2000). The court found that taxpayers could have retained substantial rights in research results even if they do not have

the exclusive rights to the research. The court also found that the Service's analogy to Section 1235 was unsound because the law does not require that the taxpayer retain all substantial rights.

The taxpayer argued that the test for determining whether a researcher retained substantial rights in its research was whether the research contract gave the researcher the right to use the results of the research in its business without paying for the right. The Service conceded that LM retained the right to use and disclose the results of its research, but asserted that right was not a substantial right, primarily, because the taxpayer had to pay to use the research under the contracts recoupment provisions.

The decision included a succinct definition of the types of research projects that are considered "funded" and thus not eligible for the credit:

These regulations [Treas. Reg. § 1.41-5(d)] imply two scenarios in which the taxpayer's research will be considered "funded" by another person. The first is when the parties agree that payment shall not be contingent on the success of the research. If the taxpayer's research will be paid for by another person whether or not the research succeeds, the research is funded and the expenditures are not entitled to the tax credit. In contrast, if the taxpayer will be paid only if it succeeds in its research for the other party, the taxpayer's research will not be considered funded . . . .

The second scenario in which a taxpayer's research can be considered 'funded' or 'paid for' is when the taxpayer agrees to perform research for another person without retaining "substantial rights" to its research--when the person for whom the research is performed has 'the exclusive right to exploit the results of the research' and the taxpayer "must pay for the right to use the results of the research." . . . If the taxpayer does not have the right to use or exploit the results of the research, its expenditures are not entitled to the tax credit regardless whether there is an agreement that the research will be paid for only if successful, and regardless whether the taxpayer receives some 'incidental benefit' such as increased experience. On the other hand, it follows that as long as exclusive rights are not vested in "another person," the taxpayer may retain substantial rights. Treasury Reg. Section 1.41-5(d) thus implements the statute's purpose of giving a tax credit only

to those taxpayers who themselves take on the financial burden of research and experimentation to develop new techniques, equipment, and products that they can use in their businesses.

The court further concluded that a taxpayer that retains the right to use research results without paying for it has "substantial rights." The right to use the research results, even without the exclusive right, is a substantial right. The court then found, under the terms of the contracts, LM had the right to use its research without paying for it. The recoupment provisions in the contracts were for reimbursement or cost recovery to the government. These payments were not for the right to use the research results such as a royalty payment.

#### CONCLUSION

The Federal Court of Appeals opinion in Lockheed Martin Corp. v. United States did not change the standard for determining whether a taxpayer retained "substantial rights" in its research results. The determination of whether a retained right is substantial depends on the circumstances and the commercial or practical value of the retained right. However, the Federal Court of Appeals did hold that the researcher's right to use the research results without paying for it, even though the researcher's right is not exclusive, is a substantial right.

If you have any questions or comments, please contact me at (602) 207-8056.

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APPROVED:

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